

## CHAPTER 12 BANKRUPTCY, AN EXPLANATION OF THE CODE SECTIONS

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December 31, 1986

Chapter 12 Bankruptcy came into effect on November 26, 1986. This law was enacted to aid family farmers as financial difficulties in the agricultural sector continue.

Following is an explanation of the provisions of the new law. This explanation follows the law as written, section by section. A study of the explanation in comparison with the law should aid in understanding. Section references are to the amended title 11 of the United States Code, which is the Bankruptcy Code.

### SECTION 101, DEFINITION OF FAMILY FARMER

A family farmer is an individual, or an individual and spouse, operating a farm whose total debt does not exceed \$1,500,000 of which 80 percent is related to the farming operation. If the debt on the residence is separate from the farm debt that debt is not used as the 80 percent is calculated. These tests do not include undetermined amounts for which a family might become responsible; i.e., a pending law suit for an accident. The farm family must have also received 50 percent or more of their gross income from farming during the tax year preceding the year of filing bankruptcy.

It is also possible for a partnership or a corporation to be considered a family farmer and to file under Chapter 12. The partnership or corporation

must meet the \$1,500,000 and 80 percent tests of the above paragraph the same as an individual. In addition, 50 percent or more of the stock or equity must be held by one family and relatives of the family. The same family or relatives must be operating the farm. Also, 80 percent of more of the value of the assets in the partnership or corporation must be related to the farming operation. The stock of a corporation cannot be publicly traded.

In addition to the above tests the family farmer must have an annual income which is sufficiently stable and regular to enable payments under the plan which filed with the court. This is a subjective test which may be contested in court. It would seem the best time to meet this test would be in the preparation of a defensible plan.

A farming operation which cannot meet these definitions still has the other chapters of bankruptcy available. Those are chapters 7, 11, or 13.

### SECTION 1201, STAY AGAINST CREDITORS

Stay is a common concept in bankruptcy. In the broadest of terms stay means collection efforts of the creditor are put on hold. Under other chapters of the bankruptcy code as well as in Chapter 12 stay is granted to

the person or persons filing bankruptcy. Within Chapter 12 stay is also granted to a codebtor on a consumer debt. Note this stay is granted to codebtors for consumer type debt not business debt.

The creditor has the right to ask the court for relief from this stay. If the court grants the relief the codebtor again becomes liable. If a creditor files a motion for relief from stay, the debtor or codebtor must file an objection within 20 days or the stay will be lifted without an opportunity to object.

#### SECTION 1202, TRUSTEE

Chapter 12 bankruptcy cases will have a trustee appointed. The trustee is basically responsible for monitoring the plan of payments to creditors. The trustee has the ability to question the valuation of property brought into the bankruptcy, the confirmation of the plan, any modification to plan and the sale of any of the property in the bankruptcy. Also, if the farmer ceases to be the debtor in possession the trustee shall perform the duties of the debtor in possession.

The trustee is paid a percentage of the payments made under the plan. The percentage shall be 10 percent of the first \$450,000, and 3 percent on amounts over \$450,000.

The trustee within a Chapter 12 has similar duties to the trustee within a Chapter 13. Under a Chapter 11 usually no trustee is appointed.

#### SECTION 1203, RIGHTS AND POWERS OF DEBTOR

The debtor, farmer, shall be responsible for continuing to operate the business. The debtor is responsible for filing: a list of creditors, a schedule of assets and liabilities, a schedule of current income and expenditures, a statement of the debtor's financial affairs, and a plan. The plan is discussed at section 1221 and 1222.

#### SECTION 1204, REMOVAL OF DEBTOR AS DEBTOR IN POSSESSION

The farmer may be removed from being the debtor in possession upon court order. The court order may be given upon a party in interest, likely a creditor or the trustee, making such a request. Reasons for such a request would include fraud, dishonesty, incompetence, or gross mismanagement. The removal of the debtor in possession by the court can only happen after notice to the debtor and a hearing. The debtor can be removed at any time throughout the bankruptcy proceeding. It is also possible for the debtor to be reinstated as debtor in possession.

#### SECTION 1205, ADEQUATE PROTECTION

A secured creditor is entitled to adequate protection after bankruptcy has been filed. This means the creditor's position should be able to be protected from further deterioration. A creditor is entitled to adequate protection because of

concepts like stay; use, sale or lease of property in the bankruptcy; and the debtor being able to grant a priority to creditors who enable the operation of the business after the filing of bankruptcy.

Adequate protection may be provided by: 1) requiring cash payments to a creditor; 2) providing an additional or replacement lien; 3) paying the farmland creditor a reasonable rent based upon rental value, net income and earning capacity of the property; or 4) the granting of such other relief as will adequately protect the value of property securing a claim or of ownership interests in leased property.

The Chapter 12 law introduces one new concept into adequate protection which has troubled real estate creditors. That is the concept of a fair rental payment in lieu of the regular amortized payments. This can be a drastic reduction in the payments. Creditors are responding by indicating they will not be focusing as much on adequate protection until after the confirmation of plans is achieved.

#### SECTION 1206, SALES FREE OF INTERESTS

This provision mainly stops blockage of a sale of farmland or equipment by a creditor. The creditor is protected by having their interest attach to the proceeds from the sale. Any sales under this provision are by the trustee and only after notice and a hearing.

#### SECTION 1207, PROPERTY OF THE ESTATE

The bankruptcy estate includes, basically, all the property of the farmer brought into bankruptcy, plus property acquired by the farmer after date of filing plus earnings from services performed by the farmer after the date of filing.

#### SECTION 1208, CONVERSION OR DISMISSAL

A Chapter 12 case can be converted to a Chapter 7 upon request of the debtor. Also, on request of the debtor the court shall dismiss a case under this chapter. This request can happen at any time during the proceedings. This request will not be granted if the case has previously been converted from Chapter 7 or 11 to Chapter 12.

It is also possible for a creditor, trustee or other party in interest to request a dismissal from a Chapter 12. Such a dismissal can only be granted after notice and a hearing.

Reasons a party in interest might request a dismissal include: unreasonable delay or gross mismanagement by the debtor to the detriment of creditors; nonpayment of fees and charges; failure to timely file a plan; failure to commence making timely payments set forth by a confirmed plan; denial of confirmation of a plan and denial of a request for additional time to modify the plan or file another; material default by the debtor in

meeting terms of a confirmed plan; revocation of a confirmed plan and denial of acceptance of a modified plan; meeting of the conditions set forth in a confirmed plan; or continuing diminution of the estate with little chance to change the situation.

A Chapter 12 case can be converted to a Chapter 7 or dismissed upon a showing that the debtor has committed fraud. This is the only provision of the bankruptcy code which allows involuntary liquidation of a farmer.

The creditor's ability to request a conversion or dismissal for one of many reasons should cause debtors to comply with deadlines and attempt to manage the business according to the plan. If a dismissal occurs the protection of bankruptcy is lost.

#### SECTION 1221, FILING THE PLAN

The plan for making payments to creditors must be filed within 90 days of the date of the order for relief. The order for relief is considered to be granted on the same day the bankruptcy is filed. The court may grant an extension of this 90 day deadline but only if facts show the reasons are substantially justified. It is anticipated extensions will only be granted for unusual circumstances. As will be discussed under sections 1223 and 1229, plans which are filed may be modified.

#### SECTION 1222, CONTENTS OF PLAN

The plan sets forth how creditors of the bankruptcy

estate are to be compensated. The funds which are to be dispersed to creditors are submitted to the trustee for supervision and control.

The plan is to provide for full payment of claims entitled to priority. Those claims include: administration expenses; up to \$2,000 of wages earned by each employee within 90 days before filing the bankruptcy; claims of up to \$2,000 for contributions to employee benefit plans per employee; deposits of up to \$900 per individual for the purchase, lease, or rental of personal, family or household goods or services; and unsecured claims of governmental units.

The plan is to provide equal treatment for each claim within a particular class of claims.

The plan may provide the following: a class or classes of unsecured creditors; modify the rights of holders of secured or unsecured claims; for the curing or waiving of default; for the payment of unsecured claims concurrently with the payment of secured claims; curing of default and the maintenance of payments while the case is pending on claims which will not be paid entirely until after the case is dismissed; for the assumption, rejection, or assignment of any executory contract (contracts to be completed in the future); for payment of a claim from property of the estate; for the sale or distribution of all the property of the estate; for payment of secured claims for a period which exceeds the

bankruptcy; for vesting of the property in the debtor on confirmation of the plan; and include other appropriate provisions.

The plan is to provide for completion within three years. However, payments for secured claims may extend beyond the period of bankruptcy. The court may, for cause, extend a Chapter 12 up to no longer than 5 years.

#### SECTION 1223, MODIFICATION OF THE PLAN BEFORE CONFIRMATION

A debtor may modify the submitted plan any time before confirmation so long as the modification meets the criteria for plans set forth in section 1222.

#### SECTION 1224, CONFIRMATION HEARING

The court shall hold a hearing on the plan to achieve confirmation of it. Creditors (secured and unsecured), trustees and other parties of interest may object to the confirmation. The hearing and confirmation are to be concluded within 45 days after the filing of the plan. For cause the court may grant an extension of this 45 day period.

The law attempts to have plans submitted and confirmed within 135 days of the filing date. This is a short time period purposely set to expedite Chapter 12 proceedings.

#### SECTION 1225, CONFIRMATION OF PLAN

This section identifies the standards for court

acceptance of the plan submitted by the debtor. Those tests are: 1) the plan must comply with the provisions of Chapter 12 law; 2) amounts to be paid before confirmation have been paid; 3) the plan is proposed in good faith; 4) each unsecured claim must receive an amount equal to or exceeding what would have been received if the debtor would have liquidated on date of filing; 5) each holder of a secured claim has accepted the plan, retains a lien on the secured property, receives a value for the claim not less than the value on the effective date of the plan, or that the property is turned over to the creditor; and 6) the debtor will be able to make payments under the plan.

Holders of unsecured claims do not have the ability to accept or reject the plan. Unsecured creditors may file an objection to the plan. If such an objection is filed the court may not approve the plan unless either such claim or claims are paid in full or all disposable income in the 3 to 5 year period is applied to make payments under the plan. Disposable income means income which is received by the debtor and which is not reasonably needed for support of the debtor and his dependents or for expenditures necessary for continuation, preservation, and operation of the business.

#### SECTION 1226, PAYMENTS

All payments made to creditors under the plan are to be made by the trustee. Funds received prior to confirmation of the plan are

to be held by the trustee. If the plan is not confirmed the funds held by the trustee shall be returned to the debtor after expenses incurred in filing and management of the bankruptcy to the date of dismissal are paid. If the plan is confirmed the trustee shall make all payments to creditors under the plan. Before such payments are made to creditors, the trustee shall be sure the priority expenses identified in section 1222 above and trustee fees are paid.

#### SECTION 1227, EFFECT OF CONFIRMATION

Confirmation of a plan is an important event. Confirmation has the effect of binding the debtor, creditors, partners in the case of a partnership and equity holders in the case of a corporation. This effect of binding is true whether or not a creditor accepted the plan and whether or not a creditor receives payments under the plan.

#### SECTION 1228, DISCHARGE

Discharge is to occur as soon as possible after the debtor has completed payments under the plan. Discharge releases the debtor from all debts provided for under the plan with some exceptions. If the plan provided for continued payments to secured creditors over a time longer than the bankruptcy period those future payments are not discharged. If the debtor elected by filing a waiver with the court prior to obtaining a discharge to have certain dischargeable debts continue those debts would not be discharged.

Creditor claims which were not listed when the bankruptcy was filed are not discharged. Certain claims are not dischargeable in bankruptcy; i.e., certain taxes; credit obtained under false pretenses; alimony, maintenance or support payments owed a former spouse or a child under court order; and certain student loans.

#### SECTION 1229, MODIFICATION OF PLAN AFTER CONFIRMATION

A plan may be modified during the bankruptcy period on request of the debtor, the trustee, or the holder of an allowed unsecured claim. Reasons for modifying a plan are: 1) to increase or reduce the amount of payments on claims of a particular class, 2) to extend or reduce the time for payments, or 3) to alter the payment to a particular creditor if payments have been made to that creditor other than under the plan. Extensions cannot cause the bankruptcy to continue beyond 3 years unless the court approves an extension, which may extend the period up to 5 years.

#### SECTION 1230, REVOCATION OF AN ORDER OF CONFIRMATION

A party in interest, usually a creditor or the trustee, can request a revocation of a confirmed plan. The reason for such a request would be if a confirmation was obtained by fraud. A request for revocation must be made within 180 days after confirmation.

## SECTION 1231, SPECIAL TAX PROVISIONS

This section of Chapter 12 law relates only to state and local taxes, not to Federal taxes. Any state or local income taxes resulting within the bankruptcy estate will be the obligations of the estate, not in any way the independent responsibility of the debtor. Also any state or local tax imposed because of property transfers to or from the bankruptcy estate are to be waived. An example transfer tax in Ohio is the tax imposed when real estate ownership is changed.

It is important to note that this section does not relate to Federal taxes. With Chapters 7 and 11 any federal income taxes incurred within the estate are not the responsibility of an individual debtor. This federal tax shelter within Chapters 7 and 11 is not extended to partnerships or corporations, just to individuals. The possibility of taxes remaining the responsibility of Chapter 12 debtors could cause some individual debtors to file a Chapter 7 or 11 if major federal taxes liabilities are projected.

## SECTION 256, CONVERSION FROM CHAPTER 11 TO CHAPTER 12

This section of the law makes it possible for a debtor to request the court to convert a Chapter 11 case to Chapter 12. Other sections of the code make it possible for a Chapter 11 bankruptcy to be converted to a Chapter 13 if the debtor qualifies. The code in other sections also makes it possible to convert from a Chapter 11, 12, or 13 to a Chapter 7.

Farmers cannot be forced to convert to a Chapter 7 liquidation plan from a Chapter 11, 12, or 13 with one exception. The Chapter 12 law at section 1208 permits an involuntary conversion from a Chapter 12 to a Chapter 7 by the court upon a showing that the debtor has committed fraud.